

(3) *Examples.* The following examples illustrate the determination of whether an employee is benefiting under a plan for purposes of section 410(b).

*Example 1.* An employer has 35 employees who are eligible under a defined benefit plan. The plan requires 1,000 hours of service to accrue a benefit. Only 30 employees satisfy the 1,000-hour requirement and accrue a benefit. The five employees who do not satisfy the 1,000-hour requirement during the plan year are taken into account in testing the plan under section 410(b) but are treated as not benefiting under the plan.

*Example 2.* An employer maintains a section 401(k) plan. Only employees who are at least age 21 and who complete one year of service are eligible employees under the plan within the meaning of § 1.401(k)-1(g)(4). Under the rule of paragraph (a)(2)(i) of this section, only employees who have satisfied these age and service conditions are treated as benefiting under the plan.

*Example 3.* The facts are the same as in *Example 2*, except that the employer also maintains a section 401(m) plan that provides matching contributions contingent on elective contributions under the section 401(k) plan. The matching contributions are contingent on employment on the last day of the plan year. Under § 1.401(m)-1(f)(4), because matching contributions are contingent on employment on the last day of the plan year, not all employees who are eligible employees under the section 401(k) plan are eligible employees under the section 401(m) plan. Thus, employees who have satisfied the age and service conditions but who do not receive a matching contribution because they are not employed on the last day of the plan year are treated as not benefiting under the section 401(m) portion of the plan.

(b) *Former employees benefiting under a plan—(1) In general.* A former employee is treated as benefiting for a plan year if and only if the plan provides an allocation or benefit increase described in paragraph (a)(1) of this section to the former employee for the plan year. Thus, for example, a former employee benefits under a defined benefit plan for a plan year if the plan is amended to provide an ad hoc cost-of-living adjustment in the former employee's benefits. In contrast, because an increase in benefits payable under a plan pursuant to an automatic cost-of-living provision adopted and effective before the beginning of the plan year is previously accrued, a former employee is not treated as benefiting in a subsequent plan year merely because the former

employee receives an increase pursuant to such an automatic cost-of-living provision. Any accrual or allocation for an individual during the plan year that arises from the individual's status as an employee is treated as an accrual or allocation of an employee. Similarly, any accrual or allocation for an individual during the plan year that arises from the individual's status as a former employee is treated as an accrual or allocation of a former employee. It is possible for an individual to accrue a benefit both as an employee and as a former employee in a given plan year. During the plan year in which an individual ceases performing services for the employer, the individual is treated as an employee in applying section 410(b) with respect to employees and is treated as a former employee in applying section 410(b) with respect to former employees.

(2) *Examples.* The following examples illustrate the determination of whether a former employee benefits under a plan for purposes of section 410(b).

*Example 1.* Employer A amends its defined benefit plan in the 1995 plan year to provide an ad hoc cost-of-living increase of 5 percent for all retirees. Former employees who receive this increase are treated as benefiting under the plan for the 1995 plan year.

*Example 2.* Employer B maintains a defined benefit plan with a calendar plan year. In the 1995 plan year, Employer B amends the plan to provide that an employee who has reached early retirement age under the plan and who retires before July 31 of the 1995 plan year will receive an unreduced benefit, even though the employee has not yet reached normal retirement age. This early retirement window benefit is provided to employees based on their status as employees. Thus, although individuals who take advantage of the benefit become former employees, the window benefit is treated as provided to employees and is not treated as a benefit for former employees.

*Example 3.* The facts are the same as *Example 2*, except that on September 1, 1995, Employer B also amends the defined benefit plan to provide an ad hoc cost-of-living increase effective for all former employees. An individual who ceases performing services for the employer before July 31, 1995, under the early retirement window, and then receives the ad hoc cost-of-living increase, is treated as benefiting for the 1995 plan year both as an employee with respect to the

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early retirement window, and as a former employee with respect to the ad hoc COLA.

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**§ 1.410(b)-4 Nondiscriminatory classification test.**

(a) *In general.* A plan satisfies the nondiscriminatory classification test of this section for a plan year if and only if, for the plan year, the plan benefits the employees who qualify under a classification established by the employer in accordance with paragraph (b) of this section, and the classification of employees is nondiscriminatory under paragraph (c) of this section.

(b) *Reasonable classification established by the employer.* A classification is established by the employer in accordance with this paragraph (b) if and only if, based on all the facts and circumstances, the classification is reasonable and is established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification.

(c) *Nondiscriminatory classification*—(1) *General rule.* A classification is nondiscriminatory under this paragraph (c) for a plan year if and only if the group of employees included in the classification benefiting under the plan satisfies the requirements of either paragraph (c)(2) or (c)(3) of this section for the plan year.

(2) *Safe harbor.* A plan satisfies the requirement of this paragraph (c)(2) for a plan year if and only if the plan's ratio percentage is greater than or equal to the employer's safe harbor percentage, as defined in paragraph (c)(4)(i) of this section. See § 1.410(b)-9 for the definition of a plan's ratio percentage.

(3) *Facts and circumstances*—(i) *General rule.* A plan satisfies the requirements of this paragraph (c)(3) if and only if—

(A) The plan's ratio percentage is greater than or equal to the unsafe harbor percentage, as defined in paragraph (c)(4)(ii) of this section, and

(B) The classification satisfies the factual determination of paragraph (c)(3)(ii) of this section.

(ii) *Factual determination.* A classification satisfies this paragraph (c)(3)(ii) if and only if, based on all the relevant facts and circumstances, the Commissioner finds that the classification is nondiscriminatory. No one particular fact is determinative. Included among the facts and circumstances relevant in determining whether a classification is nondiscriminatory are the following—

(A) The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is to be nondiscriminatory. Reducing the employer's cost of providing retirement benefits is not a relevant business reason.

(B) The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is to be nondiscriminatory.

(C) Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce. In general, the more representative the percentages of employees benefiting under the plan in each salary range, the more likely the classification is to be nondiscriminatory.

(D) The difference between the plan's ratio percentage and the employer's safe harbor percentage. The smaller the difference, the more likely the classification is to be nondiscriminatory.

(E) The extent to which the plan's average benefit percentage (determined under § 1.410(b)-5) exceeds 70 percent.

(4) *Definitions*—(i) *Safe harbor percentage.* The safe harbor percentage of an employer is 50 percent, reduced by  $\frac{3}{4}$  of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. See

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paragraph (c)(4)(iv) for a table that illustrates the safe harbor percentage and unsafe harbor percentage.

(ii) *Unsafe harbor percentage.* The unsafe harbor percentage of an employer is 40 percent, reduced by  $\frac{3}{4}$  of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent. However, in no case is the unsafe harbor percentage less than 20 percent.

(iii) *Nonhighly compensated employee concentration percentage.* The nonhighly compensated employee concentration percentage of an employer is the percentage of all the employees of the employer who are nonhighly compensated employees. Employees who are excludable employees for purposes of the average benefit test are not taken into account.

(iv) *Table.* The following table sets forth the safe harbor and unsafe harbor percentages at each nonhighly compensated employee concentration percentage:

Nonhighly compensated employee concentration percentage	Safe harbor percentage	Unsafe harbor percentage
0-60	50.00	40.00
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38.00	28.00
77	37.25	27.25
78	36.50	26.50
79	35.75	25.75
80	35.00	25.00
81	34.25	24.25
82	33.50	23.50
83	32.75	22.75
84	32.00	22.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00
95	23.75	20.00

Nonhighly compensated employee concentration percentage	Safe harbor percentage	Unsafe harbor percentage
96	23.00	20.00
97	22.25	20.00
98	21.50	20.00
99	20.75	20.00

(5) *Examples.* The following examples illustrate the rules in this paragraph (c).

*Example 1.* Employer A has 200 nonexcludable employees, of whom 120 are nonhighly compensated employees and 80 are highly compensated employees. Employer A maintains a plan that benefits 60 nonhighly compensated employees and 72 highly compensated employees. Thus, the plan's ratio percentage is 55.56 percent  $([60/120]/[72/80]=50\%/90\%=0.5556)$ , which is below the percentage necessary to satisfy the ratio percentage test of § 1.410(b)-2(b)(2). The employer's nonhighly compensated employee concentration percentage is 60 percent  $(120/200)$ ; thus, Employer A's safe harbor percentage is 50 percent and its unsafe harbor percentage is 40 percent. Because the plan's ratio percentage is greater than the safe harbor percentage, the plan's classification satisfies the safe harbor of paragraph (c)(2) of this section.

*Example 2.* The facts are the same as in *Example 1*, except that the plan benefits only 40 nonhighly compensated employees. The plan's ratio percentage is thus 37.03 percent  $([40/120]/[72/80]=33.33\%/90\%=0.3703)$ . Under these facts, the plan's classification is below the unsafe harbor percentage and is thus considered discriminatory.

*Example 3.* The facts are the same as in *Example 1*, except that the plan benefits 45 nonhighly compensated employees. The plan's ratio percentage is thus 41.67 percent  $([45/120]/[72/80]=37.50\%/90\%=0.4167)$ , above the unsafe harbor percentage (40 percent) and below the safe harbor percentage (50 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the relevant facts and circumstances.

*Example 4.* Employer B has 10,000 nonexcludable employees, of whom 9,600 are nonhighly compensated employees and 400 are highly compensated employees. Employer B maintains a plan that benefits 600 nonhighly compensated employees and 100 highly compensated employees. Thus, the plan's ratio percentage is 25.00 percent  $([600/9,600]/[100/400]=6.25\%/25\%=0.2500)$ , which is below the percentage necessary to satisfy the ratio percentage test of § 1.410(b)-2(b)(2). Employer B's nonhighly compensated employee concentration percentage is 96 percent  $(9,600/10,000)$ ; thus, Employer B's safe harbor percentage is 23 percent, and its unsafe harbor percentage

is 20 percent. Because the plan's ratio percentage (25.00 percent) is greater than the safe harbor percentage (23.00 percent), the plan's classification satisfies the safe harbor of paragraph (c)(2) of this section.

*Example 5.* The facts are the same as in *Example 4*, except that the plan benefits only 400 nonhighly compensated employees. The plan's ratio percentage is thus 16.67 percent ( $[(400/9,600)/(100/400)] = 4.17\%/25\% = 0.1667$ ). The plan's ratio percentage is below the unsafe harbor percentage and thus the classification is considered discriminatory.

*Example 6.* The facts are the same as in *Example 4*, except that the plan benefits 500 nonhighly compensated employees. The plan's ratio percentage is thus 20.83 percent ( $[(500/9,600)/(100/400)] = 5.21\%/25\% = 0.2083$ ), above the unsafe harbor percentage (20 percent) and below the safe harbor percentage (23 percent). The Commissioner may determine that the classification is nondiscriminatory after considering all the facts and circumstances.

[T.D. 8363, 56 FR 47645, Sept. 19, 1991; 57 FR 10954, Mar. 31, 1992]

**§ 1.410(b)-5 Average benefit percentage test.**

(a) *General rule.* A plan satisfies the average benefit percentage test of this section for a plan year if and only if the average benefit percentage of the plan for the plan year is at least 70 percent. A plan is deemed to satisfy this requirement if it satisfies paragraph (f) of this section for the plan year.

(b) *Determination of average benefit percentage.* The average benefit percentage of a plan for a plan year is the percentage determined by dividing the actual benefit percentage of the nonhighly compensated employees in plans in the testing group for the testing period that includes the plan year by the actual benefit percentage of the highly compensated employees in plans in the testing group for that testing period. See paragraph (d)(3)(ii) of this section for the definition of testing period.

(c) *Determination of actual benefit percentage.* The actual benefit percentage of a group of employees for a testing period is the average of the employee benefit percentages, calculated separately with respect to each of the employees in the group for the testing period. All nonexcludable employees of the employer are taken into account for this purpose, even if they are not benefiting under any plan that is taken into account.

(d) *Determination of employee benefit percentages—(1) Overview.* This paragraph (d) provides rules for determining employee benefit percentages. See paragraph (e) of this section for alternative methods for determining employee benefit percentages.

(2) *Employee contributions and employee-provided benefits disregarded.* Only employer-provided contributions and benefits are taken into account in determining employee benefit percentages. Therefore, employee contributions (including both employee contributions allocated to separate accounts and employee contributions not allocated to separate accounts), and benefits derived from such contributions, are not taken into account in determining employee benefit percentages.

(3) *Plans and plan years taken into account—(i) Testing group.* All plans included in the testing group under § 1.410(b)-7(e)(1), and only those plans, are taken into account in determining an employee's employee benefit percentage.

(ii) *Testing period.* An employee's employee benefit percentage is determined on the basis of plan years ending with or within the same calendar year. These plan years are referred to in this section as the relevant plan years or, in the aggregate, as the testing period.

(4) *Contributions or benefits basis.* Employee benefit percentages may be determined on either a contributions or a benefits basis. Employee benefit percentages for any testing period must be determined on the same basis (contributions or benefits) for all plans in the testing group.

(5) *Determination of employee benefit percentage—(i) General rule.* The employee benefit percentage for an employee for a testing period is the rate that would be determined for that employee for purposes of applying the general test for nondiscrimination in §§ 1.401(a)(4)-2, 1.401(a)(4)-3, 1.401(a)(4)-8 or 1.401(a)(4)-9, if all the plans in the testing group were aggregated for purposes of section 410(b). Thus, if employee benefit percentages are determined on a contributions basis, each employee's employee benefit percentage is the aggregate normal allocation rate that would be determined for the

employee under § 1.401(a)(4)-9(b)(2)(ii)(A) (if the plans in the testing group include both defined benefit and defined contribution plans), the allocation rate that would be determined for the employee under § 1.401(a)(4)-2(c)(2) (if the plans in the testing group include only defined contribution plans), or the equivalent normal allocation rate that would be determined for the employee under § 1.401(a)(4)-8(c)(2) (if the plans in the testing group include only defined benefit plans). Similarly, if employee benefit percentages are determined on a benefits basis, each employee's employee benefit percentage is the aggregate normal accrual rate that would be determined for the employee under § 1.401(a)(4)-9(b)(2)(ii)(B), the normal accrual rate that would be determined for the employee under § 1.401(a)(4)-3(d), or the equivalent accrual rate that would be determined for the employee under § 1.401(a)(4)-8(b)(2), depending on whether the plans in the testing group include both defined benefit and defined contribution plans, only defined benefit plans, or only defined contribution plans.

(ii) *Plans with differing plan years.* If not all the plans in the testing group share the same plan year, § 1.410(b)-7(d)(5) would ordinarily prohibit them from being aggregated for purposes of section 410(b). In such a case, employee benefit percentages are determined by applying the rules of paragraph (d)(5)(i) of this section separately to each subset of plans in the testing group that share the same plan year (or the same accrual computation period) and aggregating the results for all plans in the testing group. Thus, an employee's employee benefit percentage is determined as the sum of these separate employee benefit percentages that are determined consistently for all the plans in the testing group (except for differences attributable solely to the differences in plan years).

(iii) *Options and consistency requirements.* In determining employee benefit percentages under this paragraph (d)(5), any optional or alternative methods or rules available for determining rates in §§ 1.401(a)(4)-2, 1.401(a)(4)-3, 1.401(a)(4)-8, or 1.401(a)(4)-9, whichever is applicable, may be applied. Thus, for example, employee ben-

efit percentages may generally be calculated using any of the alternative methods of determining average annual compensation or plan year compensation under § 1.401(a)(4)-12, and using any underlying definition of compensation that satisfies section 414(s). Except as otherwise specifically permitted, the determination of employee benefit percentages must be made on a consistent basis for all employees and for all plans in the testing group as required by §§ 1.401(a)(4)-2(c)(2)(vi), 1.401(a)(4)-3(d)(2)(i), 1.401(a)(4)-8(b)(2)(iv), 1.401(a)(4)-8(c)(2)(iv) or 1.401(a)(4)-9(b)(2)(iv).

(6) *Permitted disparity*—(i) *In general.* Permitted disparity may be imputed in determining employee benefit percentages as provided in §§ 1.401(a)(4)-2, 1.401(a)(4)-3, 1.401(a)(4)-8, or 1.401(a)(4)-9, whichever is applicable. When separate employee benefit percentages are determined for individual plans under paragraph (e)(2) of this section (or for subsets of plans that have the same plan year as described in paragraph (d)(5)(ii) of this section), permitted disparity may be imputed for an employee only in one individual plan (or subset of plans) and may not be imputed for the same employee in another individual plan (or subset of plans). However, if the same average annual compensation or plan year compensation is used to determine employee benefit percentages in more than one plan, the employee's employee benefit percentages for those plans may be summed prior to imputing permitted disparity.

(ii) *Plans which may not use permitted disparity.* Permitted disparity may be reflected in the determination of rates only to the extent that the plans for which rates are being determined are plans for which the permitted disparity of section 401(l) is available. Thus, for example, if a section 401(k) plan is included in the testing group and permitted disparity is imputed under § 1.401(a)(4)-2(c)(iv), then employee benefit percentages are determined by first calculating an adjusted allocation rate (within the meaning of § 1.401(a)(4)-7(b)(1)) without regard to the amount of allocations under the section 401(k) plan and adding to it the allocation rate for the section 401(k) plan. See § 1.401(l)-1(a)(4) for a list of